Finance Watch

Making finance serve society

Blueprint

Towards inclusive, safe and sustainable financial services for consumers

Financial inclusion for all 1

Financial services have become an essential part of EU citizen's lives. In this respect, being able to access and appropriately use basic, affordable and transparent financial services is a precondition for EU citizens to be socially integrated. Defining such set of basic services is key to being able to measure where and how citizens are financially excluded, as well as to identify new threats and opportunities. Technical innovation in financial services, for example, can lead to more easily accessible or suitable products for a broader range of citizens, but only if measures are taken to avoid discriminatory practices such as client segmentation.

Diverse and competitive financial retail market 2

In a competitive and efficient market bad practices are more easily avoided because information is standardized and products are simple, transparent and comparable. Competition and diversity of providers (in relation with the size and nature of institutions) in the financial sector is key to provide consumers with the ability to access products that suit their needs. However, there are many situational factors and inherent reasons that affect consumer's ability to take decisions in their best interest.

Simple and standardized products 3

Solely relying on transparency and information disclosure is insufficient to address market failures in retail finance. Insights from behavioral economics increasingly show that when faced with uncertainty, risk, and complexity, consumers do not always behave rationally as predicted by standard economic theory. They need access to simple and standardized products, with default options. The simple products could serve the majority of disengaged consumers in the retail finance market, while keeping options for consumers who are willing to look beyond this default product. These products would not only improve financial inclusion by providing a standard fallback option, but also serve as a benchmark for other products, challenging the sector to deliver a better deal.

Responsible behaviour and practices 4

The financial industry as a whole should fulfil its responsibility to serve the needs of citizens by offering suitable basic financial services. While the private financial sector must be profitable, it should not have adverse effects on society such as exclusion, bad indebtedness or over-indebtedness due to dangerous, exploitative or irresponsible practices.

Less finance and more sustainabiity 5

Whilst every citizen should be able to access basic financial products, the financialisation of our economy and various aspects of our lives must be called into question as well. Identifying and using only the financial services needed to ensure social inclusion can be a way to ensure a more sustainable economy and lifestyle. Proper disclosure of information related to financial products must also be ensured, to allow consumers to choose financial products on the basis of their environmental, social and governance preferences.

What citizens need

Retail financial services are a **key part of the EU economy**. As highlighted in the European Commission's Green Paper on Retail Financial Services, they account for 11.1% of the EU's GDP and provide around 33 million jobs. It is also the case that almost all consumers in the EU are retail financial service users and a basic level of access to financial products is an **important feature of being able to function and participate in society**. Therefore, a well-functioning market for retail financial services is important for both the economy and citizens of the EU.

However, **consumer confidence** in financial services providers continues to be low, and mis-selling scandals continue to occur with a worrying frequency. Given the important role that retail financial services play in the average citizen's life, **consumers need to be well protected and not exploited in this key market**.

The majority of consumers only need access to a set of **basic financial products**, which include;

a. a basic payment account with a basic means for transactions;

b. credit for important expenditures such as buying a house or a car, when affordable;

c. basic health, home and motor insurance;

d. basic savings and investment products which might be relevant in the context of pensions.

Currently many citizens and consumers experience financial **difficulties in accessing and/or using financial services and products** that meet their needs and enable them to lead a normal life in the society to which they belong (see L. Anderloni, B. Bayot et al., 2008). This is why financial inclusion is a key aspect of a well-functioning market; it refers to a process whereby people do not encounter those difficulties.

In view of society's increasing dependence on **financial services, financial inclusion is an important part of social inclusion**. Being financially excluded or over-indebted has an important impact on society as a whole, because of the link with the risk of poverty and with inequality in the ability to get back into employment, to be in good health and therefore to lead a dignified life.

It is a basic and legitimate expectation that the financial sector's business models should not harm society through negative externalities which are avoidable and that public money should not be used to resolve the negative consequences of profitable private activity. The banking sector monopoly on public savings collection should be bound to a **set of societal responsibilities such as guaranteeing financial inclusion** by providing consumers with the appropriate products that they need.

a. Payment accounts

In relation to payment accounts, consumers may experience difficulties for the following reasons: compliance with identification and residence requirements, costs related to account management and costs associated with transfers themselves, being black listed, lack of supply in a geographical area, lack of user-friendly products for specifically vulnerable users (for reasons including disability, age, migration status, level of literacy etc.), unclear terms and conditions, or unnecessarily complex rules which generate penalties and extra costs, or even bank exclusion, and excessive time taken to process payments.

Access and use of a payment account has increasingly become a necessary step to allow full social inclusion and to limit risk of social exclusion in cases of financial distress. **Exclusion therefore has a direct social impact**: it reduces citizens' economic participation and may increase public expenditure (social allowances, public housing, health costs).

The most appropriate way to resolve these issues generated by the market is through corrective regulation. A review of the **Payment Account Directive (PAD)**, which provides the right to a basic payment account, should address these difficulties in accessing and using payment accounts and their societal consequences and national authorities should guarantee its proper enforcement.

b. Consumer & mortgage credit

Credit access and use are generally seen as a key factor for economic growth – although unlimited growth based on unlimited/unregulated credit should be questioned in the context of limited resources (sustainability constraints).Whilst there is no right to credit, the lack of appropriate access can be seen as an issue when consumers are refused credit despite having a sufficient level of financial capability and creditworthiness due to credit risk analyses that do not properly consider different consumer circumstances.

Unjustified restrictions can affect social well-being. Evidence from **microfinance**, including business or personal microcredit, demonstrates not only the possibility to conduct effective creditworthiness assessments on the basis of material other than credit histories but also shows the capacity of low income (or vulnerable) people to be trustable debtors. Microfinance also demonstrates the leverage effect of small amount credit, which is suited to low income households. Therefore, this sector may have important insights for the traditional credit markets.

The same asymmetry observed in many occasions between creditors and debtors can also lead to the **exploitation of end-users** through credit dedicated to vulnerable consumers, irresponsible lending, for example when consumers can only access credit at a very high cost – such as through payday lenders and sub-prime lending. It is important to prevent credit from being misused, generating arrears and never-ending debt, leading to black listing, financial penalties, foreclosures, and, ultimately, over-indebtedness.

Consequences of these inappropriate lending practices – ranging from dealing with bad debt to heavy over-indebtedness due to exploitative or irresponsible practices – have proven costly to society in terms of social and economic costs, including by increasing the risk of financial instability, as seen in the 2007 financial crisis. This is a case, again, where private profit-making generates these social costs, and where the protection of the general interest should lead to the implementation of appropriate corrective regulation. The current EU credit directives should be reviewed and revised to help achieve this.

c. Insurance

The lack of access to insurance bears negative social, legal and financial consequences. This is particularly the case where being insured is a legal requirement (e.g. car insurance). Other kinds of insurance can, however, be effectively made compulsory due to contractual terms – for example compulsory insurance included in rental contracts, or contracts related to credit provision.

Outside of legally required insurance, many other insurance services are seen to be a very efficient tool to support households when unexpected events occur. Having appropriate insurance can prevent a vicious circle of debt from occurring if unexpected payments arise. Therefore, some insurance products, including family liability and health, are generally considered to be part of a **minimum basket of goods and services needed to prevent social harm**.

In this respect, **customer segmentation and profiling** are major barriers to broad accessibility and should be challenged when these two methods have a key role in premium cost calculation. The discriminative dimension, although legal, should be analysed to consider whether and how segmentation and profiling should be addressed through regulation, including EU anti-discrimination law.

d. Savings, basic investments & pensions

Easy and cost-efficient access to a savings account should be available to every citizen, especially in the current context of increasing life expectancy and cuts in welfare systems. Every citizen should have the same opportunity of access and, when relevant, the same incentives to save money.

A set of products should be made available in the simplest way possible, for free or at a low cost, to reduce barriers to access to savings and to limit risk of financial losses. This includes saving for important future expenditures (car, house, equipment, children's study), but also before that to allow the accumulation of assets (a safety cushion to cope with unexpected events), which significantly reduces over-indebtedness exposure.

Retail consumers who have money that they wish to invest should have access to ad hoc advice and to **simple investment products at a reasonable cost**. According to an external study by the European Commission, in the vast majority of EU countries, retail investors tend to seek advice from non-independent advisers who tend to propose between two to three in-house products (see European Commission 2018) . As a result, the investment products sold to average retail investors may have much higher fees than products sold to more sophisticated investors. For example, a CAC-40 exchange traded fund may cost around 0.4% in fees while for the equivalent fund sold at retail level in traditional 'bank assurance' models they may amount to 1.5%. This difference in fees can reduce the returns on the products significantly and puts average retail consumers at a disadvantage.

Last but not least, policy makers should invest significant research on the **future of pensions** to find solutions, including considering innovative solutions, to protect retired people from poverty and social exclusion.

➔ See also Finance Watch report "A pot at the end of the rainbow", June 2017

Sustainability

Ensuring that citizens have the same opportunity to access the services they need to be included in society does not mean that all citizens need to use all financial services products. It is important for citizens to have access where needed, but to be equally aware of the need to **consume** these services **responsibly**.

Currently consumers often do not have access to information needed to assess their financial products. This goes beyond the issue of pricing, to information on what consumers' money is invested in. Financial services providers should therefore be required to disclose information that allows consumers to take investment decisions that support their objectives – and enable them to switch to more sustainable providers if they wish. A lack of transparency prevents a fully competitive market. This should be addressed by ensuring **proper disclosure of elements related to how companies take into account environmental, social and governance criteria**.

What markets offer

Lack of efficiency and competition

When we compare the conditions generally considered to be required for **a market to be "efficient"** and the conditions prevailing in the retail financial services market, the difference is vast. On the supply side, to be efficient, the following conditions, among others, should be met: ***atomicity*** (the number of clients and providers are high enough that no one can, alone, influence the market) and ***product homogeneity*** (needed to ensure that comparison is possible, free entry and exit for market providers, no barriers). The classic market concept developed by economists is closer to a village food market in the 18th or 19th century than the highly concentrated and complex financial market of the 21st century. On the demand side, an issue is that consumers are largely unable to identify their interests and pursue them. If they were to have the necessary tools to take decisions in their best interest, then this would have an impact on the supply of products being offered. Competition to provide these products could emerge within the boundaries of what consumers would then accept.

In order to recover some efficiency in financial services so that consumers can benefit from **more competition and a better choice**, they would need have access to a truly cross-border retail financial market as well as to independent, cost-efficient financial advice in the best interest of the consumer. This can only be done by resolving one of the root causes of the lack of efficiency of the financial services retail market: complexity.

Complexity

Citizens' needs in relation to financial services have not substantially changed over the last few decades. However, products and services have constantly evolved, becoming more and more complex. This **evolution in complexity has not necessarily led to safer products that are better designed to fit the needs of consumers**; instead they have become mass-products sold on an industrial scale. Complexity can present in three ways:

(1) Product complexity: In the investment area the complexity of a given product is characterized by the number of its features. The more features a product has, the more complex it is for the investor to understand and compare it with possible alternatives. **Product complexity serves the interests of the industry** because complexity is associated with higher product profitability for providers, and also allows for several layers of fees to be introduced, which are cumulative. This explains the strong incentives financial services providers have to issue complex products – and low performance for consumers.

Financial institutions can strategically use complexity to mitigate competition as it allows them to continue to charge higher prices. Homogenous products should compete on price, and so **by creating more complex products financial institutions are able to continue to use opaque pricing structures**. The more complex a product, the higher the hidden mark-up is likely to be.

(2) Price complexity: It should also be noted that there are issues with pricing even when it comes to homogenous products, the second feature of complexity in financial services. Despite the large number of firms in the market, prices remain above marginal cost and may even rise as more firms enter.

A key problematic practice in the retail financial markets that can lead to price complexity is the client segmentation and profiling, which does not allow consumers to truly compare offers due to consumer profiling needed to finalise any real offer.

Complexity increases the market power of firms because it prevents some consumers from gaining knowledge on prices in the market, which prevents them from making informed decisions about which products to purchase. Producers of retail financial services may perpetuate this lack of understanding by making their prices more complex, thereby gaining market power and the ability to increase industry profits at the expense of consumers.

(3) Sales complexity: This refers to tied and bundled products, where there is often uncertainty around the price of a service or product. This restricts consumer's ability to shop around for better prices on one of the tied or bundled services. This in turn has an impact of competition. Tying and bundling also contributes to the complexity of products and opaque pricing for consumers.

Poor practices in the industry

In a competitive and efficient market bad practices are easily avoided because the information and understanding of the consumer is high, and products are simple which is not the case today. A lack of competition between financial services providers gives rise to the possibility of poor practices and locks consumers into products because there is no alternative. However, solely relying on transparency and information disclosure is not sufficient to address market failures persisting in retail finance. When faced with uncertainty, risk, and complexity, consumers do not always behave rationally as predicted by standard economic theory.

One area where these poor practices are particularly apparent is in the use of sales incentives for financial advisors. It is often said that products are sold, not bought. Mechanisms like sales commissions change the incentives for financial advisors, and so consumers are more likely to be offered products that suit the seller rather than the buyer.

However, sales incentives are only one of the drivers of possible poor practices. More generally, finance employees are today faced with a lot of pressure from management through the use of sales targets and different types of performance measurements, which it is important to note are not necessarily connected to financial gain.

The solutions to be implemented to improve the quality of the advice should include the ban of commissions ("inducements") as a first step, but should also include a larger set of tools: to correct misleading practices related to sales bonus incentives, to improve the general quality and simplicity of the products, to democratise the development of promising innovation tool such as robo-advice.

Ultimately, Financial advisors should give impartial advice that allows consumers to make informed decisions in their best interests: from what has been mentioned, the general management principles of financial institutions make this objective a complex challenge to be solved internally.